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CGAP

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Aid Effectiveness Initiative

Microfinance Donor Peer Reviews

APRIL 2004

Global Results: Analysis and Lessons

Seventeen development agencies participated in the Microfinance Donor Peer Reviews as part of an aid effectiveness initiative to improve donor practice.

LIST OF AGENCIES PARTICIPATING IN THE PEER REVIEW EXERCISE

Donor Agency	Date	Donor Reviewers	CGAP Reviewers
Bilateral Agencies			
Agence Française de Développement (AFD)	10-14 March 2003	Camilla Bengtsson, Sida Roland Siller, KfW	Brigit Helms Eric Duflos
Canadian International Development Agency (CIDA)	9-13 June 2003	Ross Croulet, AfDB Kate McKee, USAID	Jennifer Isern Eric Duflos
DANIDA	28 April-1 May 2003	Doris Wong, CIDA Kathy von Daeniken, SDC	Xavier Reille Eric Duflos
Department for International Development (DFID)	13-17 May 2002	Kate McKee, USAID Leila Webster, World Bank Group	Brigit Helms Alexia Latortue
Gesellschaft für Technische Zusammenarbeit (GTZ)	14-18 July 2003	Nimal Fernando, AsDB Craig Churchill, ILO	Alexia Latortue Eric Duflos
Kreditanstalt für Wiederaufbau (KfW)	14-18 Oct 2002	Anne Clerc, AFD David Ferrand, DFID	Syed Hashemi Alexia Latortue
Netherlands	19-23 May 2003	Bernd Balkenhol, ILO Mavis Owusu-Gyamfi, DFID Sanjay Sinha, EDA Rural Systems	Syed Hashemi Alexia Latortue
Norwegian Agency for Development Cooperation (NORAD)	4-7 June 2002	Gabriela Braun, GTZ Stav Zotalis, AusAID	Brigit Helms Alexia Latortue
Swedish International Development Agency (Sida)	20-24 May 2002	Richard Roberts, FAO David Stanton, DFID	Brigit Helms Alexia Latortue
Swiss Agency for Development and Cooperation (SDC)	18-22 Aug 2003	Dirk Steinwand, GTZ Johan de Waard, Netherlands	Brigit Helms Eric Duflos
US Agency for International Development (USAID)	10-18 Nov 2003	Richard Boulter, DFID Henri Dommel, IFAD	Brigit Helms Eric Duflos
Multilateral Agencies			
African Development Bank (AfDB)	6-10 May 2002	Camilla Bengtsson, Sida Stephan Boven, EBRD	Elizabeth Littlefield Alexia Latortue
Asian Development Bank (AsDB)	8-12 July 2002	Henri Dommel, IFAD David Stanton, DFID	Syed Hashemi Alexia Latortue
European Commission (EC)	24-28 March 2003	Henri Dommel, IFAD Gisela Strand, Sida	Brigit Helms Eric Duflos
International Fund for Agricultural Development (IFAD)	17-21 June 2002	Heather Clark, UNCDF/UNDP Hege Gulli, NORAD	Douglas Pearce Alexia Latortue
International Labor Organization (ILO)	10-14 Feb 2003	Hege Gulli, NORAD Peter Kooi, UNCDF/UNDP	Brigit Helms Alexia Latortue
UN Development Programme and UN Capital Development Fund (UNDP and UNCDF)	21-25 Oct 2002	Nimal Fernando, AsDB Arlina Tarigan-Sibero, KfW	Brigit Helms Alexia Latortue

Acknowledgements: The authors would like to express their gratitude to the 29 donor staff from 21 agencies who comprised the peer reviewers and/or organizers for this exercise. We would also like to thank the eight CGAP colleagues and partners who participated in reviews and field visits. They all enthusiastically embarked on these challenging yet collegial reviews, and actively contributed to the drafting of the letters to management upon which this report is largely based. Any errors or omissions, however, remain the responsibility of the authors.

EXECUTIVE SUMMARY

Tackling aid effectiveness is one of the biggest challenges facing the international development community. Early in 2002, the Consultative Group to Assist the Poor (CGAP) joined with former U.K. Secretary of State for Development Clare Short to launch a unique aid effectiveness initiative using microfinance as a test case: Microfinance Donor Peer Reviews. Championed by Ministers and Heads of Agencies, 17 development assistance agencies participated in the reviews.

Although microfinance represents a small percentage of most agencies' budgets, it is an appropriate focus for the reviews. All participating donors have agreed in principle to standards of microfinance good practice, but their performance on the ground does not uniformly reflect their commitment. CGAP facilitated and documented the reviews on behalf of the donors, and continues to provide follow-on technical support.

The Microfinance Donor Peer Reviews addressed aid effectiveness from a different perspective. Rather than concentrate on constraints at the country level, the reviews focused on donor agencies' own procedures, practices, processes and systems. The reviews were collegial exercises, involving over 900 donor staff from 21 agencies as reviewers, hosts and/or interviewees, and offering valuable opportunities for mutual learning and exchange. The reviews identified success factors and constraints to good microfinance practice, and offered concrete recommendations for change.

All participating agencies opted to publicly disclose their results, and implementation of the recommendations is underway at most agencies. Actions taken include developing new vision statements for deepening the reach of the financial sector; strengthening business plans and staffing of microfinance focal units; conducting portfolio reviews; implementing systems of project performance indicators; drafting operational "how to" notes for non-microfinance specialists; facilitating staff training; stopping non-performing credit lines; and introducing incentives for technical specialists to provide advice.

The Peer Reviews also revealed several trends in development assistance that affect aid effectiveness overall and have considerable implications for donor support of microfinance. These trends include the increasing use of new aid modalities and moving "upstream", a shift toward generalist staff among donor agencies, and the decentralization of operations.

Five core elements of effectiveness emerged from the 17 Microfinance Donor Peer Reviews. These elements, while not exhaustive, are key to improving aid effectiveness at the individual agency level. These same elements also help determine an agency's comparative advantage in microfinance vis-à-vis other donors when supporting financial services for the poor.

- *Strategic Clarity:* The coherence of an agency's vision of microfinance, and whether this vision and agency policies are in line with accepted good practice.
- *Strong Staff Capacity:* Whether the microfinance focal unit has sufficient capacity and resources to provide skilled technical support to operational colleagues. Also, whether the overall level of technical capacity is adequate to ensure quality operations.
- *Accountability for Results:* The level of knowledge of the microfinance portfolio (e.g., whether it is "visible" to the agency) and transparency on portfolio performance.
- *Relevant Knowledge Management:* How well the agency learns from its own and others' experience through the creation, dissemination and use of practical, user-friendly knowledge.
- *Appropriate Instruments:* Whether an agency has instruments that allow it to work directly with the private sector - a critical pre-condition for effectiveness in microfinance. The quality, range and flexibility of instruments are also crucial.

For each of these elements, this paper highlights current donor challenges and presents recommendations from the Peer Reviews, with specific examples of good donor practice.

The Peer Reviews mark the beginning of a long road to improving aid effectiveness in microfinance and beyond. To ensure that the Peer Review experience translates into better development impact - increased access to financial services among the world's poor - donors will need to build on management's commitment to change, identify their comparative advantage in promoting financial services for the poor and act accordingly, collaborate in ways that leverage each others' strengths, and jointly tackle common challenges.

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I. BACKGROUND

Aid effectiveness is a top priority for the international development community. Whether tackling the global Millennium Development Goals (MDGs) or working with governments on Poverty Reduction Strategies at the country level, donor agencies seek to improve their effectiveness to achieve concrete development outcomes and eliminate poverty.

Early in 2002, the Consultative Group to Assist the Poor (CGAP) joined with former U.K. Secretary of State for Development Clare Short to launch a series of Donor Peer Reviews as Part of an initiative to improve aid effectiveness, using microfinance as a test case. The Microfinance Donor Peer Reviews addressed aid effectiveness from a unique perspective. Rather than concentrate on constraints at the country level (governance, corruption, macroeconomic instability, etc.), the reviews focused on what donor agencies could most directly influence: their own procedures, practices, processes and systems. Reviews were not formal evaluations or detailed portfolio reviews. Rather, they were collegial, supportive exercises that identified success factors and constraints to good microfinance practice.

This report summarizes the findings and recommendations of 17 completed Peer Reviews and three field visits to Uganda, India and Mali.[1] It is organized in four parts. The present section provides information on the review process and initial results of the Peer Reviews. Part II explores selected trends in development cooperation that have implications for overall aid effectiveness. Part III introduces five key elements of effectiveness that emerged from the Peer Review exercise, then analyzes the challenges faced by donors, makes recommendations to improve the effectiveness of their microfinance operations, and offers examples of good donor practice. The final section of the report explores the implications of the Peer Reviews for how donors can better support financial services for the poor.

A. Microfinance as a Test Case for Aid Effectiveness

Although microfinance represents a small percentage of the budgets of most agencies, it is an appropriate technical area for review because donors have already agreed to standards of microfinance good practice, but their performance does not uniformly reflect their commitment. CGAP, as a consortium of 28 bilateral and multilateral donors and foundations working in microfinance, was well-positioned to facilitate and document the reviews on behalf of donors and to provide follow-on technical support.

Microfinance is a rapidly changing field. In the past, microfinance was principally associated with microenterprise credit provided by NGOs. Today, it encompasses a diverse range of financial services (savings, credit, insurance, and payment transfers) provided to a wide variety of clients (poor landless women, retirees, urban families, rural entrepreneurs) through many different types of institutions (banks, NGOs, credit unions).
Increasingly, leaders in the field see microfinance as a means to expand and deepen the financial sector, rather than simply to provide credit to specific target clients (e.g., microentrepreneurs). For donors, a financial sector approach to microfinance entails building the capacity of retail-level financial intermediaries, as well as establishing links with new types of actors, such as commercial banks, rating agencies, investors and policy makers.

B. Review Process

The review teams were generally comprised of two senior technical staff from other donor agencies involved in microfinance, plus two CGAP staff. The teams visited the head office of each agency for one week. During that time, team members met or spoke on the phone with an average of more than 50 people, interviewing a wide cross-section of staff and partners. The people interviewed held a variety of technical, administrative, operational, and managerial positions, both at headquarters and in the field.

The teams then presented an initial analysis and

[1] A list of the agencies that participated in the reviews and field visits can be found on the inside cover of this document. For complete information on the Peer Reviews, please refer to the "Donor Effectiveness - Donor Peer Reviews" section of the CGAP website at www.cgap.org.

specific recommendations to top management and staff of the agency. The presentation and ensuing feedback from agency personnel formed the basis of a letter to management with recommendations,[2] submitted some eight weeks after the actual review.[3]

Many agencies have indicated that the review process, analysis and recommendations are relevant beyond microfinance. The following lessons can inform donor agencies about how to conduct successful exercises of this nature.

Composition of the review team

Participating donor agencies appreciated that peers - not consultants - were the reviewers. The fact that members of the review teams faced many of the same problems in their own agencies made the exercise less threatening than typical evaluations and fostered greater empathy and candor. Reviewers valued gaining in-depth understanding of other agencies and widening their network of contacts with donor colleagues.

Pre-review planning

Given the short time frame, preparation was indispensable to the reviews. It was particularly important to carefully pre-select staff who would be interviewed. The Peer Review teams also studied relevant documents and were briefed by the microfinance focal point (the person or unit responsible for microfinance within the agency) before the review. Despite intensive, time-consuming preparatory work, focal points considered the reviews a worthwhile investment.

Management involvement

In a notable but uncommon occurrence for many agencies, top management and staff engaged in detailed discussions on constraints for effectiveness. Without the active participation of management (and non-microfinance specialist staff in regional and operational departments), the Peer Reviews would have risked being perceived as a closed exercise. The likelihood of subsequent organizational change was minimal unless top management was fully engaged in the exercise. When open to all, the de-briefing sessions offered a non-threatening opportunity for management and staff to reflect together on the *modus operandi* of their agency.

Relationship with focal point

The relationship between the review teams and the focal points was somewhat delicate. An implicit purpose of the reviews was to support the efforts of the focal point to improve microfinance practices within the agency. There was a fine line, however, between supporting the focal points and maintaining objectivity. The review team depended on the focal points to set the agenda and steer them in the direction of major areas of concern. Yet the process could backfire if the teams were perceived as co-opted by the focal point. Given their different roles, the review teams and focal points sometimes differed in their opinions about challenges and possible solutions.

Openness and awareness of donor staff

All review teams were impressed with the interest that donor staff showed in the reviews. Staff had specific ideas on what does and does not work and why, as well as on how to enhance the effectiveness of their agencies. The findings and recommendations of the review teams largely reflected the views of the many donor staff who gave generously of their time.

C. Initial Results

The Peer Reviews generated results at several levels, including individual agency decisions, actions, and shifts in mindset. Other results cut across numerous agencies and are apparent in changed relationships and a heightened sense of shared purpose. The following points illustrate some of the initial results of the reviews.

Lever for overall aid effectiveness

Several heads of agencies found the Peer Reviews relevant to improving effectiveness within their agencies beyond microfinance. Analysis of the specific technical area of microfinance applied to much of the agencies' work in other sectors of development,

[2] The letters made public by AfDB, EC and NORAD are edited versions, while those of AFD, AsDB, CIDA, DANIDA, DFID, GTZ, ILO, IFAD, KfW, the Netherlands, Sida, SDC, UNDP, USAID are available as originally submitted to management. The letters can be found in the "Donor Effectiveness—Donor Peer Reviews" section of www.cgap.org. See E. Duflos, B. Helms, and A. Latortue, *Letters to Management: Findings and Recommendations; Aid Effectiveness Initiative: Microfinance Donor Peer Reviews* (Paris: CGAP, 2004) for a complete set of the letters.

[3] The terms of reference, developed by participating donors and CGAP staff, can be found on the CGAP website (www.cgap.org) in the "Donor Effectiveness—Donor Peer Reviews" section.

particularly in private sector development. The methodology of the Peer Reviews was also seen as a quick and effective means to generate new ideas for improving other sectors.

In the spirit of strengthening overall aid effectiveness, CGAP is now establishing linkages with other institutions concerned with the issue, such as the OECD/Development Assistance Committee (DAC), the United States Treasury, and the Executive Directors of the World Bank. These links are important conduits for reinforcing the messages of the Peer Reviews on what is required for aid effectiveness. They also help maintain the momentum needed to institute changes.

Transparency and increased "networking"

In a noteworthy commitment to transparency, all agencies opted to publicly disclose their letters to management, which contain candid analysis and practical recommendations. Relationships among staff, both within and among development agencies, also deepened as a result of the Peer Reviews, which involved over 900 donor staff from 21 agencies as reviewers, hosts, and/or interviewees. Full disclosure combined with intense interaction has provided the donor community as a whole with a better basis for understanding the most promising role that each agency can play in supporting financial services for the poor.

Agency implementation of recommendations

The response to the Peer Reviews by senior management has been overwhelmingly positive and many agencies have made a serious commitment to bring about specific changes.[4] These actions include developing new vision statements for deepening the reach of the financial sector; strengthening the staffing and business plans of microfinance focal units; implementing a system of project performance indicators; drafting operational "how to" notes for non-microfinance specialists; facilitating staff training; stopping non-performing credit lines; and introducing incentives for technical specialists to provide advice.

Improvement in CGAP services

CGAP staff benefited from in-depth exposure to the daily realities of its member donors. Ten CGAP staff took part in the reviews and field visits. Their improved understanding of donor operations has deeply influenced the way in which the CGAP operational team works and the services it offers. For example, in response to donor demand for information tailored to the needs of non-microfinance specialists, CGAP developed a comprehensive, online set of information products specifically for donor staff.[5] CGAP also partnered with the Special Unit for Microfinance at UNCDF to design and offer a new training course for donors that integrates many of the findings of the reviews.

II. TRENDS AFFECTING AID EFFECTIVENESS

The Peer Reviews revealed several trends in development assistance that are affecting aid effectiveness as a whole. Many of these trends are the result of political decisions made by parliaments or ministries, usually with the objective of improving the impact of development assistance. However, several trends have serious implications for effective donor support of pro-poor financial services.

A. New Aid Modalities and Moving "Up-stream"

Donor agencies today are focused on aid effectiveness and reaching the MDGs. Consequently, they are applying new approaches to achieve lasting systemic change, reduce transaction costs for recipient countries, and increase local ownership of development efforts. Many agencies are moving away from the "project" approach toward a "program" approach. This new strategy includes direct budget support to national governments and Sector Wide Approaches, which are usually linked to Poverty Reduction Strategies. In this context, most of the agencies reviewed demonstrated a strong interest in participating in policy dialogue, or working at the "upstream" level.

While beneficial to aid effectiveness overall, the focus on larger programs and policy work poses certain trade-offs for expanding financial

[4] See A. Latortue, *Update on Donor Actions Taken; Aid Effectiveness Initiative: Microfinance Donor Peer Reviews* (Paris: CGAP, 2004) for detailed examples of the follow-up and reforms of many agencies following the Peer Reviews.

[5] See the Donor Information Resource Centre (DIRECT) at www.cgap.org/direct.

services for the poor. More generally, it raises important questions about the role of the private sector in development. Microfinance is a private sector activity that calls for significant technical inputs, but is usually incompatible with large budgets and direct government intervention. The program approach often pushes agencies to include credit components in large, multi-sector programs. These components are often designed, implemented and supervised without appropriate microfinance expertise.

A number of donor agencies appear to believe that policy work does not require as much technical capacity as the support of retail-level programs. This assumption can lead donors to push too early for laws or regulations that are ill-adapted to microfinance. The upstream focus also poses another trade-off. Staff can lose their technical skills if policy work removes them too far from retail-level work. Yet some donor staff maintain that it is precisely their ability to make concrete technical arguments based on direct knowledge of current retail practice that gives them the credibility to influence policymakers.

B. Move Toward More Generalist Staff

The majority of staff in most donor agencies are generalists. This is unsurprising, given low incentives to specialize in a technical area. Agencies are tackling an increasingly complex and ambitious development agenda and they tend to reward staff with strong communication skills who can work on many issues and levels. Staff in most agencies feel overwhelmed by the proliferation of mandates. They must work at the retail level and policy level; coordinate both internally and with host governments, other donors, the private sector and civil society; and take into account cross-cutting themes such as gender, HIV/AIDS, and the environment.

The proliferation of mandates leaves staff stressed, with little time to update technical skills or participate in knowledge networks. Lack of time also prevents generalists from seeking specialist advice on the design of microfinance programs, limiting the programs' chance of success. The move towards generalist staff is particularly acute at the field level, where many of the best career advancement opportunities are found. Technical staff now sometimes fear that moving to the field may erode, rather than strengthen, their technical capacity, and often need to plan deliberately to retain their skills (staff at both Sida and SDC have taken this approach).

Moreover, program budgets are increasing in almost every development agency that was reviewed, while staffing levels remain frozen. This situation places an additional burden on staff, who feel greater pressure to disburse large amounts of money quickly. The lack of staff resources risks producing large multi-sector programs with insufficient technical attention to the individual components. The overall trend towards larger programs exacerbates this problem.

C. Decentralization

Several agencies, including DFID, GTZ, UNDP and USAID, are highly decentralized. They delegate significant parts of the design, monitoring and evaluation of development projects to field offices. Most other donors are rapidly moving in this direction. Decentralization enables agencies to design programs that are more responsive to local needs, as well as to more closely monitor their performance and use of funds. Agencies with staff on the ground can also collaborate better with other donors in the same country and sector.

Managing a decentralized structure poses several challenges, however. The more independent field offices become, the harder it is to ensure that standards and accepted practices are implemented across the board. Managers of field offices also run the risk of becoming more interested in maintaining positive relationships with local governments than upholding the good practice standards of their own agencies - the flip side of responsiveness.

In addition to quality assurance and best practice issues, knowledge management is another important challenge in decentralized agencies. Good knowledge management requires two-way interaction: experiences from the field need to feed back into the knowledge base of the agency, and field staff need access to the knowledge of headquarters and other field offices.

III. ELEMENTS OF AID EFFECTIVENESS

The 17 Microfinance Donor Peer Reviews yielded five core elements of aid effectiveness at the individual agency level. While not exhaustive, these elements help determine an agency's comparative advantage in microfinance vis-à-vis other donors when supporting financial services for the poor.

- *Strategic Clarity*: The coherence of an agency's vision of microfinance, and whether this vision and agency policies are in line with accepted standards of good practice.
- *Strong Staff Capacity*: Whether the focal unit has sufficient capacity and resources to provide skilled technical support to operational colleagues. Also, whether the overall level of technical capacity throughout the agency is adequate to ensure quality operations.
- *Accountability for Results*: The level of knowledge of the microfinance portfolio (e.g., whether it is "visible" to the agency) and transparency on portfolio performance.
- *Relevant Knowledge Management*: How well the agency learns from its own and others' experience through the creation, dissemination and use of practical, user-friendly knowledge.
- *Appropriate Instruments*: Whether an agency has instruments at its disposal that allow it to work directly with the private sector - a critical pre-condition for effectiveness in microfinance. The quality, range and flexibility of instruments are also crucial.

For each of these five elements of effectiveness, this section highlights current donor challenges and presents recommendations from the Peer Reviews. It then describes some examples of good donor practice that development agencies have put in place to improve their effectiveness.

A. Strategic Clarity

The coherence of an agency's vision of microfinance, especially the relationship between microfinance operations and broader development goals, affects quality at every level. Agencies with strategic clarity know where they want to go and align their behavior and operations to that vision. A coherent approach (rather than a splintered one) does not stifle diversity and creativity, but rather defines the boundaries of a common commitment to principles of good practice. A high-quality microfinance policy is important, but not sufficient; policies must be internalized by staff to translate into results on the ground.

Challenges

Unclear agency-wide vision of microfinance

Although agencies demonstrate remarkable clarity on their overarching development goals (i.e., poverty reduction and the Millennium Development Goals), the same is rarely true for microfinance. With few exceptions, there is a dissonance in most agencies concerning the definition of microfinance, and how it can contribute to their broad development goals. Donor staff often understand microfinance to be different things, and tend to define it in narrow terms, for example as an input for agricultural production, a resource transfer to a specific target group, or part of a strategy for deepening the financial sector. Lack of a coherent agency-wide vision that explains how microfinance contributes to core development goals can result in uneven project quality and conflicting strategies. Most important, it can erode the impact of microfinance on poor people.

Uncertainty about the role of the private sector in development work

Private sector departments are a fairly recent phenomenon within donor agencies. The majority of donor agencies remain uncomfortable working with the private and financial sectors. For many donor staff, financial sector development means working at the "high end" of the banking sector (e.g., with the Ministry of Finance and Central Bank, and on bank restructuring) and preventing (or cleaning up after) financial crises. The relatively few donors that have financial sector development departments often created them in the wake of the 1997 Asian financial crisis. Poverty Reduction Strategy Papers and the "program" approach to development, which emphasize public sector budget support, further call into question exactly how private sector work like microfinance fits into the bigger picture of development assistance.

Inadequate internalization of microfinance policies
Good microfinance policy is not enough. A clear policy that defines microfinance standards of good practice and agency goals in microfinance is insufficient for effectiveness. Even the best policy has little value unless it is internalized by the staff who design, implement and appraise microfinance programs. Several agencies have developed policy or strategy papers in line with good practice, but failed to make these policies relevant to the work of non-microfinance specialist staff. The proliferation of policies also creates "policy fatigue". As a result, donor microfinance policies may not be understood, accepted or used by staff and good practices are not systematically reflected in an agency's microfinance operations.

Recommendations and Good Practice

Craft a vision statement
A vision statement should lay out an agency's vision for microfinance in language appropriate for managers and non-microfinance specialists. It should define microfinance, explain its role within the financial sector, and describe how it contributes to the agency's development goals. The statement, which should be short, should also explain how the agency intends to support financial services for the poor based on its comparative advantage. The process of developing the statement is often more important than the document itself. Using a participatory approach that consults a broad range of staff is critical to ensure buy-in from staff and management, so that the statement becomes a reference document for the whole agency. In the Netherlands, the Ministry of Development Cooperation and the members of the Dutch Microfinance Platform - a network of some ten private and public Dutch institutions that support microfinance - launched a process to define a shared vision statement for microfinance.

A vision statement can also build on the policy papers of other agencies. The Financial Sector Development policies of SDC, DANIDA, and the German Federal Ministry for Economic Co-operation and Development (Bundesministerium für wirtschaftliche Zusammenarbeit und Entwicklung, BMZ), for example, provide an excellent basis for such statements.

Operationalize the vision statement
Ensuring that a microfinance vision statement is understood and internalized by the entire organization requires a creative approach. Top management should signal its commitment to the vision statement by making references to it in key speeches and addresses to staff. Management should also commit to disseminating the vision throughout headquarters and field offices.

To help staff apply the vision to operational work, the microfinance focal point within an agency should translate it into clear guidance on specific operational issues. This guidance can take the form of short notes or "dos and don'ts" that can be used by program managers and non-microfinance specialist staff in their everyday work. The Financial Sector Group of DFID, for example, is developing a series of notes to guide the agency's operations and sharpen clarity on its microfinance objectives.

Embed microfinance organizationally within financial sector and/or private sector development
Microfinance requires a private sector approach to ensure that poor people have permanent access to financial services. Only financially sustainable institutions can provide on-going social benefits to their clients. A financial sector perspective advocates appropriate roles for the key stakeholders in microfinance (i.e., the government, private sector, and civil society) and seeks to avoid introducing market distortions. These are two important pre-requisites for building sustainable microfinance institutions. Technical guidance to microfinance operations should therefore be the ultimate responsibility of a financial sector (or private sector) department, which would maintain appropriate links to colleagues in relevant areas such as social and rural development.
As part of its re-organization, AFD placed microfinance within its recently created financial sector team. At Sida, microfinance is now located within private sector development. To emphasize the importance of microfinance as part of private and financial sector development, AsDB shifted responsibility for microfinance from the Agriculture, Environment, and Natural Resources Division to the Governance, Finance and Trade Divisions.

B. Strong Staff Capacity

The Peer Reviews confirmed a direct link between staff with solid microfinance technical expertise and the quality of an agency's microfinance operations. Within donor agencies, most microfinance programs are managed by non-microfinance specialist staff, functionally splitting those with technical expertise on the one hand, and those with control over money on the other.

Challenges

Insufficient technical capacity among the staff who design and implement programs

Overall technical capacity in microfinance is low in the majority of donor agencies. Low technical capacity means that insufficient technical resources exist relative to the requirements of good microfinance practice. The scarcity of resources raises the question of how microfinance projects can be designed, backstopped and monitored by staff with appropriate knowledge. The overall trend toward generalist staff in most agencies makes this problem more acute and causes concern for future microfinance operations. Typical project managers work on diverse sectors and have little time to attend training sessions in technical areas that represent 5-20 percent of their portfolios. Even when agencies organize training events, dropout rates are high, especially when such events are held in close proximity to the work place.

Over-reliance on outsourced expertise

Many donor agencies rely extensively on external consultants, who often design, implement and monitor microfinance programs. Unfortunately, outsourced expertise is not a substitute for internal staff capacity. Experience shows that excessive use of external consultants can prevent agencies from deepening their institutional knowledge, learning from experience and innovating. This problem is especially serious when agencies repeatedly use a limited pool of consultants without sufficient competition, quality control or performance reviews. Also, those who manage contracts with consultants or operators often lack the baseline knowledge needed to judge their performance.

Uneven technical inputs in the early design stage

The provision of technical inputs in the early stages of project design is a strong precondition for quality projects. In most agencies, however, microfinance specialists are not always aware of upcoming microfinance operations, especially when financial services are a component of multi-sector projects and thus do not figure in the project name or coding systems. Generalist staff typically do not have incentives to systematically seek technical inputs early in the project design stage. Such inputs are obtained primarily on a voluntary, ad-hoc basis. When specialists do become involved in projects, it is often as part of a formal review process - far too late to make serious modifications and prevent major mistakes. Sadly, a badly designed microfinance program or component (one with subsidized lending rates, for example) may not only be ineffective, but it may also distort the overall financial market.

Optimal role and organization of the microfinance focal point

One of the key challenges for focal points is to properly prioritize their activities. Their ability to work effectively depends on the structure of their agency (centralized or de-centralized), their level of responsibility (technical support and/or portfolio management), the balance between their internal and external activities (e.g., promoting good practice internally versus participating in international fora), and their incentives to engage non-specialist staff on microfinance issues.

In many agencies, focal points do not spend enough time spreading best practices within headquarters and field offices, preferring to launch their own projects. Working with non-microfinance specialists who may be skeptical, sometimes even hostile, can be unrewarding. As a result, focal points are often more reactive than proactive, working only with the most interested and open colleagues who approach them.

Recommendations and Good Practice

Invest in full-time microfinance technical staff

The four most effective agencies among the 17 that were reviewed - DFID, GTZ, KfW and USAID - have strong technical focal points.

Beyond the focal point, staff have a solid basic knowledge of microfinance principles even though they work in this area only a small proportion of their time. In small bilateral agencies, even one microfinance advisor can bring about significant change in a relatively short period of time. The focal points at Sida and NORAD, for example, have had a big impact on non-microfinance specialists in their agencies.

Grouping some or all microfinance specialists in one unit may be advantageous to build cohesion, credibility and an agency-wide vision for financial services for the poor. An alternative approach is to place specialists closer to operational staff. AsDB, for example, recently hired new staff with significant microfinance knowledge in regional departments, and a financial sector specialist for its technical advisory unit. DFID combines a strong central technical unit with three full time equivalent experts in the newly created Financial Sector Team with financial specialists located in strategic countries in the field. In Uganda, microfinance practitioners cited the high number of technically qualified donor staff in the country as a significant contribution to the overall development of the microfinance sector.

Increase access to technical expertise

Hiring additional headquarter or core staff is not always financially or politically feasible. Options to increase access to microfinance expertise without increasing overall headcount include reassigning staff with microfinance expertise; recruiting national specialists in the field; concentrating technical resources on countries with the largest microfinance portfolios; placing a team of experts on retainer for technical troubleshooting; and signing contracts with local or regional service providers. Recruiting and training national microfinance specialists not only builds local capacity, but it also provides a sustainable and cost-effective source of technical support in-country.

To strengthen its technical monitoring capacity, IFAD is now contracting specialists based in Africa and Central America to provide technical support to its field projects. When outsourcing to consultants, it is imperative to create feedback loops to integrate their learning into the knowledge base of the agency. Focal points should also establish consultant rosters that track individuals' performance, while seeking to continuously identify fresh sources of expertise.

Offer tailored training to generalists working on microfinance

Agencies can significantly improve microfinance knowledge by developing a minimum level of technical capacity among program or regional officers with a microfinance portfolio. The purpose of this baseline capacity is to make non-microfinance specialists informed consumers of microfinance technical expertise, able to seek advice at the right time. Training materials and formats should take into account the time constraints of busy managers, agencies' priority concerns and the participants' current level of microfinance knowledge. In addition to training for non-microfinance operational staff, UNCDF offers UNDP Deputy Resident Representatives customized training opportunities to become conversant in key technical and policy issues in microfinance.

Create incentives for increased knowledge exchange between specialist and generalist staff

Management should make knowledge exchange a part of the work of all staff. Incentives need to run in two directions: the focal point must have an incentive to engage non-microfinance specialists, and program managers must see the benefits of seeking technical advice from microfinance experts. At KfW, technical specialists are motivated to support colleagues throughout the organization because this function is embedded in their TORs and workplans, and team leaders from other regions comment on their annual performance evaluations. Knowledge exchange between microfinance specialists and non-specialist program staff should become a systematic part of all TORs and annual reviews. Management should accordingly reward focal units that pro-actively cultivate technical relationships with operational staff.

Management should also encourage non-microfinance specialists to call upon specialist input during the development stage of a new microfinance project. The focal point can assist this process by disseminating a list of technical specialists (both within and outside of the

agency) who can help non-microfinance specialists. Other incentives include offering generalist staff scholarships to international training events and highlighting success stories of their programs in widely-read agency publications.

Refine the role of the microfinance focal point
The experience of the Peer Reviews strongly suggests that any agency interested in directly supporting microfinance needs a technical focal point. Focal points provide an effective entry-point for technical exchange and dissemination within donor agencies. While there is no single approach, the Peer Reviews indicate that focal units that prioritize spreading good practices among non-specialist colleagues at headquarters and in the field may be more effective. This is especially true in agencies where microfinance projects originate from many different departments and from decentralized country offices. In response to a recommendation in its letter to management, the Board of Directors of AfDB reshaped the mandate, staffing and business plan of its microfinance focal point. Its new Central Microfinance Unit now spends most of its time supporting colleagues instead of implementing its own programs.

Regardless of the type of donor agency, it is essential that focal points:

- provide technical expertise in the early stages of project design, both for stand-alone microfinance projects and financial sector components within larger programs;
- facilitate networking and knowledge sharing among staff working on microfinance by disseminating information, promoting dialogue and offering in-house workshops and training; and
- work to establish strategic clarity within their agencies on microfinance and how it contributes to achieving overall development goals.

Focal points need to balance what they often perceive as more interesting work (e.g., launching and managing their own projects, networking with internal and external microfinance specialists, attending international conferences), with the critical but possibly less intellectually stimulating role of spreading good microfinance practices within their agencies.

C. Accountability for Results

Accountability refers to full transparency regarding the purpose, content and performance of the microfinance portfolio. It also refers to an agency's responsibility for the efficient and effective use of its funds (often those of constituent taxpayers). Transparency about performance of microfinance programs is critical for aid effectiveness. Only with accurate information can agencies make sound decisions on whether to continue, extend, terminate or replicate a program. Yet, the Peer Reviews found that most of the agencies that were reviewed do not know how much money they have invested in microfinance, nor do they have sufficient knowledge of the performance of their microfinance operations.

Challenges

Significant approval pressure
Pressure to move money, often within a designated fiscal year or project approval cycle, is present in every donor agency. It is especially acute in multilateral agencies. The imperative to get projects approved often takes precedence over setting up systems to ensure accountability, overrides technical discipline, and leads to the distortion of immature financial markets. Even when technical staff point out flaws in project design, project approval deadlines can take priority over modifications. This pressure, observed during the Mali field visit, pushes staff to design larger programs, often with no regard to the absorptive capacity of target markets and clients. Approval pressure has particularly serious effects on private sector activities like microfinance because good projects typically require small budgets but large technical inputs. It can be both difficult and harmful to move large amounts of money in microfinance.

Invisibility of the microfinance portfolio
Microfinance projects often originate in numerous departments; no one person or unit is responsible for centralizing funding decisions. Lack of a coherent agency-wide vision of microfinance, moreover, can mean that community development funds or other types of revolving credit funds may not be considered microfinance. Finally, internal project coding systems often cannot flag microfinance when it

is a minority component of a larger project (and does not appear in the project title). The overall lack of visibility of the microfinance portfolio prevents agencies from providing appropriate technical support to these programs. It also makes learning from successes and failures impossible, increasing the probability that the agency will repeat the same mistakes.

Lack of performance tracking

With many agencies uninformed about the scope and size of their microfinance portfolios, it follows that they have insufficient knowledge of the performance of their microfinance operations. Indeed, nearly all the agencies that were reviewed did not adequately track the performance of their microfinance investments. Even when collected, reporting information tends to be activity-based (amount disbursed, number of training events, etc.) rather than performance-based (e.g., health of financial intermediaries, client satisfaction).

Few agencies conduct systematic external evaluations of their microfinance initiatives, which prevents them from making appropriate management decisions based on lessons learned. As a consequence, ineffective projects or project components that distort local markets and waste development money persist and are sometimes even renewed, while highly performing programs do not receive the recognition they deserve. Finally, most agencies do not report the results of their microfinance programs externally, and thus cannot compare their performance with that of other agencies. At a time when several agency leaders are promoting results-based management, microfinance provides a clear example of a sector where performance should and can be more systematically measured and further utilized for management decisions.

Recommendations and Good Practice

Enlist top management to combat approval pressure

Developing a culture of quality programs in donor agencies requires a clear message from the top. While difficult to implement, top agency officials and executive boards should align incentives to reduce approval pressure and reward good performance. With respect to quality microfinance, the use of credit lines in larger programs should be analyzed carefully by technical specialists prior to approval. A focus on quality may require a change in policy or procedures. For example, AFD's top management recently decided that microfinance projects no longer have to comply with the required average size of projects for the organization as a whole, allowing them to proceed as smaller operations.

Obtain basic information on the portfolio

Strategies to improve quality and results should be based on knowledge of the existing portfolio, including all credit components, funds and credit lines. Agencies should modify their current monitoring systems to flag and track all projects with financial services, even when they are a minority component of a larger project. In preparation for the Peer Reviews, many donors compiled aggregate portfolio information for the first time. Although the task is difficult, agencies should continue the process and aim for progressive improvements in the quantity and quality of information collected. For example, as part of the follow-up to its Peer Review, UNDP launched a portfolio review of its field-level operations.

Develop a performance measurement framework

Agencies urgently need to collect basic information on the performance of their microfinance programs. For example, information on the number of borrowers/depositors, loan portfolio quality and financial sustainability should be routinely recorded in annual program reports. Agencies should also systematically integrate such indicators in program proposals, contractual agreements, terms of reference, and monitoring and evaluation documents. Among the donors that were reviewed, USAID systematically collects the most basic information on its portfolio via its Microenterprise Results Reporting (MRR) system.

Microfinance is an area of development for which accepted indicators of performance have already been established. When possible, performance measurement frameworks should be harmonized among donors and the actual performance of each agency's portfolio compared with internationally accepted benchmarks. To accomplish this task, agencies can use the Microfinance Information

eXchange (MIX), an internet-based information platform for sharing information on microfinance performance. Program managers can ask partners to report performance information directly to the MIX. IFAD and the Dutch Microfinance Platform have recently decided to use the MIX for project reporting. The MIX team is preparing to train staff from both groups to use the platform and to help them design a pilot test. Harmonized reporting reduces the administrative burden on microfinance institutions. In Uganda, for example, 15 donor agencies (including AfDB, DFID, EC, NORAD and USAID) have developed a single Performance Monitoring Tool (PMT) that their Ugandan partners can use for all donor reporting.

Introduce performance-based contracts. Agencies need tools to hold their microfinance partners and contractors accountable for their results. Relationships at all levels and with all partners (apexes, microfinance institutions, technical implementers) should be spelled out in performance-based contracts, based on a clear definition of the ultimate project goal and a coherent exit strategy for the donor. Performance milestones with clearly defined targets could be used to determine if additional funding would be released. NORAD, for example, started using performance-based contracts with PRIDE in Uganda. When using such contracts, relevant staff must be trained to interpret and act on monitoring reports. If partners fail to meet targets without providing adequate explanation, managers must be empowered to stop further funding.

Use incentives to increase staff accountability. Systems for accountability will not work unless staff is motivated to use them. Management should consider introducing incentives to promote transparency and good performance in microfinance. Positive incentives could include priority access to training and conference opportunities, awards for successful microfinance operations, internal publicity on the intranet, and even monetary incentives. GTZ, for example, has financial and non-financial incentives to reward good staff performance. Agencies that truly link annual performance evaluations and promotions to quality work encourage staff to do their best.

D. Relevant Knowledge Management

Knowledge Management (KM) - the creation, dissemination and utilization of knowledge - is about transforming information into usable knowledge and ensuring that it reaches the right people at the right time. When knowledge management enables agencies to learn from their own and others' experience, it greatly contributes to effectiveness.

Challenges

Lack of systems to capture and use internal and external knowledge
Although the majority of agencies have informal networks, systematic cross-fertilization of ideas within and among regional and sectoral divisions rarely occurs. Flows of information between field operations and head office technical units are also weak. The lack of a KM system is particularly acute when KM is only one part of the responsibility of technical staff in a given department. A single person or department cannot engage unilaterally in knowledge management. The absence of clear roles and incentives for the exchange of knowledge inhibits institutional learning in microfinance and prevents agencies from adapting new programs based on previous successes and failures.

Lack of exchanges in the field
In many of the agencies that were reviewed, there are no mechanisms that facilitate communications among countries so that lessons learned and success stories can be shared. Agency staff are often not aware of their own agency's innovations and often do not communicate with one another within the same organization. This isolation is particularly problematic for agencies that are highly decentralized.

Unsuitable packaging of information
A key challenge of knowledge dissemination is to repackage the burgeoning volume of internal and external microfinance information into a more digestible form. Though an important component of knowledge management, research does not always translate into improved practices on the ground. Staff feel bombarded by too much information that is not directly relevant to their daily work. Overstretched donor staff require brief,

operational technical knowledge accessible when they need it: "just in time," not "just in case".

Recommendations and Good Practice

Make knowledge management a responsibility of all staff

KM is not limited to disseminating information. It must become an ingrained operational habit of all agencies. In headquarters and in the field, staff should share useful information with colleagues as an automatic reflex. To do so, however, they need appropriate incentives and tools.

> ***Internally,*** effective KM requires a clear signal from top management about its importance. Managers should allocate staff time and budget resources for meaningful KM. They should also include KM as an explicit function in staff job descriptions, annual work plans and performance evaluations. For microfinance focal points, KM is the core of their mission and a large proportion of their time should be dedicated to it. Internal knowledge networks (such as the Financial Services Team and the Savings and Credit Forum) enable SDC to exchange, disseminate and retain knowledge within the organization.
>
> ***Externally,*** agencies should exchange more knowledge with other donors and partners through their focal points. They should also disseminate key internal publications more widely. Such exchanges could occur through different vehicles, such as donor working groups, CGAP annual meetings, staff secondments and international conferences. USAID has launched a series of research programs that have produced significant knowledge and have become public goods for the international community, including other donors.

Build internal specialist networks

Many of the agencies reviewed have staff with some knowledge and/or interest in microfinance. In some cases, they have formed informal networks that meet periodically and exchange e-mails to brainstorm ideas, find solutions to problems, and share lessons learned. A collegial atmosphere and informal meetings provide important opportunities to discuss "hot issues", specific projects, or even a new strategy for microfinance. IFAD, AsDB, and EC have thematic groups composed of staff from various departments that reinforce the focal point and help transmit key messages more deeply within the agencies. The EC focal point, for example, worked closely with the Sub-Thematic Group on Microfinance to draft a work plan to implement its Peer Review recommendations.

Agencies should make efforts to integrate field staff into such networks because they are often the repository of institutional knowledge in individual countries. Local staff also have their own informal networks and can offer insight into the local context.

Top management should ensure that time and financial resources are available to promote these networks more formally. GTZ, for example, has allocated significant resources to build up strong regional sector networks, composed of specialists from the field and head office, which meet regularly. By transforming KM into a personal and joint staff objective, GTZ succeeded in creating a real culture of intellectual exchange and shared responsibility for building knowledge throughout the organization.

Develop user-friendly KM tools to exchange knowledge and lessons learned

Ultimately, success depends on whether knowledge is applied to problem solving and decision making. KM works when staff learn from internal and external experiences and feed that knowledge back into the design of new initiatives. Focal points should gather, synthesize and re-package available information about good donor practices in a form accessible to both specialists and non-microfinance specialists. They should also experiment with a variety of media to disseminate information as widely as possible.

There is a real thirst for practical, operational guidelines on microfinance. Agencies are encouraged to develop short, 2-3 page documents that outline the most effective ways to tackle specific challenges in supporting financial services for the poor. UNDP, for example, has begun to write short "how to" briefs on microfinance topics of relevance to project staff, such as microfinance and HIV/AIDS, gender, and post-conflict situations.

E. Appropriate Instruments

A wide range of funding instruments is required to support microfinance well. These instruments include grants, loans, loan guarantees and equity participation, and are used to build institutional capacity, provide technical assistance, fund lines of credit, facilitate the access of financial institutions to local capital, bolster equity, launch policy initiatives and build financial infrastructure (such as credit rating agencies and auditors). Effective donor instruments in microfinance accommodate small projects focused primarily on strengthening private sector institutions. All instruments should be used flexibly, with disbursements linked to the attainment of clear performance goals.

Challenges

Inability to work directly with the private sector or civil society

Many donors are constrained to work directly with government entities. This problem is especially relevant for multilateral development banks, the largest public-sector funders in microfinance. Unfortunately, their main instrument - loans to governments - is not consistent with good microfinance practice. Experience has shown that governments should not be directly involved in the delivery of financial services or the management of microfinance initiatives. Government ministries and project management units usually lack the technical skills and political independence needed to manage microfinance projects. Also, governments are often understandably reluctant to take loans for small technical assistance projects, even though such assistance is vital to support permanent access to financial services for the poor. The more appropriate role for governments would be to help create a supportive policy environment that allows the private and financial sectors, including microfinance, to function properly.

There are, of course, exceptions to this rule. A few state banks and apex funding facilities have managed to protect microfinance activities from political interference by creating a firewall between them and other subsidized government programs.

Inappropriate use of instruments

Even when agencies can work directly with private sector entities, they do not always use the instruments at their disposal to successfully build permanent access to financial services for poor people. Common problems include excessive funding of large credit lines that cannot be disbursed safely and distort local markets; rigid promotion of markets and products that reflect donor priorities instead of those of clients; slow procedures that cause liquidity crises in financial intermediaries waiting for disbursements; lack of proper sequencing of instruments (e.g., using debt instruments for start-up technical assistance); continual funding without concern for performance; and lack of risk-taking.

Poor performance of credit components

A significant portion of donor microfinance funding takes the form of credit components within multi-sector projects. These components can be grants or loans and have different names in various agencies like credit lines, community funds, or revolving funds. These components rarely adhere to the principles of good microfinance practice, nor do they easily adapt themselves to local demand and absorptive capacity. Those who design multi-sector projects frequently assume credit to be a binding constraint to meeting the development objectives of the overall project, but this is not always true. From their vantage point, credit is seen more as a resource transfer to a specific group than as a tool for building permanent access to financial services. Offering credit in this manner can induce poor clients to invest in inappropriate activities, contribute to their indebtedness, distort financial markets, and encourage corruption. Credit components often languish undisbursed in apex funding facilities, have little lasting impact and decapitalize over time. They are unsustainable and tend to disappear after the end of a project.

Recommendations and Good Practice

Take a private sector approach

Whether working directly with the private or public sector, donors should complement private capital, not displace it. Instruments should be structured to enable the selection of specialized implementing partners rather than to design credit schemes from scratch. Such an

approach requires a clear exit strategy to make sure that subsidies are temporary and that donor funding leaves behind institutions that can continue to provide services beyond the life of the project. It also implies that donors should seek risky but promising opportunities that would not immediately attract private investors. In fact, this type of risk-taking should be the hallmark of public vis-à-vis private capital in microfinance. Among the agencies that were reviewed, USAID has both a strong capacity and history of working successfully with the private sector.

Even though it works mostly with loans to governments, IFAD managed to avoid many of the common pitfalls by working with an existing financial institution in Armenia, and establishing clear selection and performance criteria. The project also enabled the government to blend grants and commercially-priced loans to ensure sufficient revenues to repay the IFAD loan.

Match funding instruments to sectoral needs

Insufficient retail-level capacity remains the number one constraint to building pro-poor financial systems. Donors should continue to concentrate their support on building retail-level capacity. Relative to other development sectors like education, health or infrastructure, microfinance requires small projects with intensive technical inputs, but relatively modest budgets. These programs need flexible, patient funding over a significant period of time. CIDA, for example, has used grant funding to support retail-level institutions for the past 35 years, contributing to the development of important microfinance providers in West Africa. The flexibility to respond quickly to a promising opportunity can also be essential to a donor's ability to support microfinance. DANIDA, for example, retains unallocated funds in its program budgets, giving the agency notable funding flexibility.

Exploit the range of existing instruments more fully

Agencies should more fully exploit their existing instruments by matching and sequencing them to the specific needs of different institutions and markets. For younger institutions and start-ups, for example, a grant might be more appropriate than a guarantee, concessional loan, or equity participation.

KfW employs a range of instruments in microfinance, and its purchase of the German Investment and Development Company (DEG) in 2001 provides greater flexibility to make equity investments in financial intermediaries. This equity instrument has proved critical in KfW's successful "Greenfield" strategy of supporting start-ups in Eastern Europe and the Balkans. In the Netherlands, the Ministry of Development Cooperation can leverage a wide range of funding instruments through the Dutch Microfinance Platform. These instruments allow the Netherlands to support many types of institutions that reach a diverse range of clients. When donors do not have a wide range of available instruments, they should partner with others that have complementary instruments to leverage each others' strengths and improve their overall effectiveness.

Phase out credit components unless they conform to good practice

Whenever feasible, financial services for the poor should not be included as minority components of multi-sector projects, but be stand-alone projects. Microfinance specialists should collaborate closely with colleagues in other sectors and departments to avoid inclusion of credit lines in programs that do not receive sufficient technical supervision. Following its Peer Review, the EC's top management decided to cease funding new credit lines that often distort markets and have limited impact on the poor.

IV. IMPLICATIONS FOR THE FUTURE: NEXT STEPS

Donor agencies have invested a great deal of time and energy in completing these reviews, achieving some remarkable progress. But serious challenges remain: much donor funding of microfinance remains ineffective and does not adhere to accepted principles of good practice. Donors wishing to contribute effectively to microfinance should achieve minimum competency in each of the five elements of effectiveness to ensure adherence to basic standards of good practice.

This section suggests ways in which the donor community can retain the momentum generated by the Peer Reviews to enhance the development impact of microfinance funding,

both at the individual agency level and as a community of donors. Specifically, donors need to build on management commitment to implement the Peer Review recommendations. In addition, each agency is encouraged to further define its unique contribution to promoting financial services for the poor and act in accordance with this comparative advantage, both globally and in specific countries. Donor agencies are also urged to collaborate in ways that leverage each others' comparative advantage. Finally, it seems worthwhile for donor agencies to jointly tackle several common challenges that were identified in the Peer Reviews.

A. Build on High-level Commitment

With the active involvement of heads of agencies and ministers, the Peer Reviews created an exciting momentum for reform and improved aid effectiveness. The reviews demonstrated that many of the challenges faced by agencies are not only technical, but often structural and organizational. Solutions require the firm support and commitment of top leadership. Ultimately, success will be determined by the extent to which political commitments translate into changes in organizational culture, behavior and the quality of field operations.

The February 2004 meeting in Paris, *Leveraging our Comparative Advantage to Improve Aid Effectiveness*, provided the leadership of the 17 participating agencies with an excellent opportunity to reflect together on how to improve aid effectiveness and assure mutual accountability for change. Together, the 17 agencies committed themselves to take the following additional steps:

1. **Codify good practices.** Current joint guidelines of good practices are nearly 10 years old, and require updating, both to incorporate the lessons from the Peer Reviews and to make them easier to apply to operations. New guidelines should include, among other things, a code of conduct for using subsidies to work with the private sector and guidance on the best use of different instruments available to bilateral and multilateral donor agencies. Agency leaders commit to sending clear, strong messages to all operational staff in at least two areas: (i) a requirement to consult with government, all other donors, and stakeholders before approving any new support in a specific country or with specific institutions to ensure complementarity and avoid undermining others in the market; and (ii) accountability and transparency on performance of the portfolio are more important than "looking good"; and transparency is critical to reaching the shared vision of creating sustainable access to financial services for poor and low-income people.

2. **Share and leverage staff capacity and knowledge.** Agency leaders concur that a strong internal technical capacity is essential to manage or outsource microfinance operations. However, all agencies cannot and should not make equally intensive investments in building staff capacity and knowledge management systems. Therefore, they should seek to leverage and build on their technical capacity and knowledge by encouraging cross-agency secondments, drawing on expertise in the private sector, investing in their national staff, delegating programs to those agencies with strong technical staff capacity (especially when that technical capacity is decentralized) where appropriate, strengthening and scaling-up networks, engaging in joint training, and building and contributing to common knowledge management systems like an internet portal.

3. **Take the Peer Review process and recommendations to the field.** Building on the decentralized structure of many agencies, the Peer Reviews should increase the ownership, voice and participation of colleagues, partners and stakeholders (government and private organizations) at the country level. Activities in specific partner countries should be undertaken to a) obtain the feedback of field-level stakeholders beyond the donor community; and b) test and document cases of collaboration among donors with complementary strengths.

4. **Conduct two-year follow-up.** In two years' time, agencies plan to reconvene to discuss which steps they are taking, individually and collectively, to implement the Peer Review recommendations. Each agency should

assess and track progress towards the recommendations of its Peer Review. As part of the follow up, agencies could choose to undergo a voluntary "checkup" review. These lighter reviews should explicitly incorporate performance benchmarking.

B. Identify and Act on Comparative Advantage

Building financial systems that work for the poor - the majority of the world's population - is a daunting task. Today, demand far exceeds supply for financial services, and market failures continue to block poor people's access. Continued donor support of the sector remains vital. The range of required donor engagements encompass working with diverse types of financial intermediaries (e.g., banks, cooperatives, postal systems), engaging in policy dialogue with governments and other stakeholders, and helping to build industry infrastructure. At the same time, not every agency can or should work on all these different levels.

Donors can use the five core elements of effectiveness as one input to identify their comparative advantage in promoting financial services for the poor. Combined with other agency-specific considerations, these elements can help guide donor actions in a given country context and/or type of intervention. For example, decentralized decision-making and technical expertise is an important success factor for microfinance operations that require constant dialogue and technical support, especially policy work. Similarly, a long track record in a particular country or region can be critical for credibility and give an agency a local comparative advantage.

The Peer Reviews highlighted potential opportunities for several agencies to align their operations with their comparative advantage, for example:

- GTZ's strengths include a cadre of in-house technical specialists, a sophisticated knowledge management strategy, efficient regional microfinance staff networks, and a long history of involvement in microfinance. These strengths make it an ideal organization to pursue highly specialized technical work to support financial intermediaries in areas like rural finance and savings mobilization. GTZ can also effectively provide hands-on support to those who implement key government policies, e.g., bank supervisors.

- NORAD is a small bilateral donor with grant funds and limited technical staff, especially at the embassy level. Its Microfinance Position Paper outlines a strategy that leverages its grants by focusing on relatively high risk innovations and industry infrastructure programs and working through Norwegian NGOs. The agency plans to only fund individual MFIs in close cooperation with other donors.

- Both KfW and AFD have diverse banking instruments that allow them to work with a range of financial institutions - primarily loans, loan guarantees, and equity participation. However, they have limited grant funding available for technical assistance, and financial disincentives to launch small capacity-building projects. These agencies could fruitfully partner with others that have flexible grant funding to broaden the range of support they can offer to partners.

- ILO's tripartite governance structure (which includes governments, workers, and industry) could offer the agency a comparative advantage in constituency-based work, such as supporting workers' banks, providing social protection through microinsurance, and generating employment through small enterprise development.

Analysis of comparative advantage can guide agencies to determine their optimal level of involvement in microfinance. Some possible action scenarios include:

Expand: The agency makes microfinance a strategic priority. It invests significantly in developing an agency-wide vision and strategy, technical staff capacity, and systems for accountability and knowledge management.

Consolidate: The agency decides to retain the same volume of microfinance spending and specialize in particular niche markets (geographical or technical) where it has a comparative advantage. The concentration of its portfolio yields greater impact for the same amount of funding.

Delegate: The agency decides that it has a limited comparative advantage, but wishes to remain involved in microfinance. It forges co-funding or other types of agreements

where the design, implementation, monitoring and evaluation of microfinance projects are delegated to an agency with a clear comparative advantage in pro-poor financial sector work.

Phase out: Based on its limited or non-existent comparative advantage, the agency decides to stop developing new microfinance operations and winds down its existing portfolio. Resources previously used for microfinance are reassigned to other development sectors where the agency can be more effective.

C. Collaborate According to Comparative Advantage

As donor agencies identify and act on their comparative advantages, they can also build on one another's strengths to form operational alliances. Collaboration makes possible the consistent application of good practice standards, a greater range of funding instruments and partners, and reduced transactions costs - enabling donors to attain far more impact together than any single donor could achieve alone.

Options for this kind of collaboration range along a wide spectrum. At one end, individual donors can agree on a common strategy for working in a particular country. Each agency can then engage with specific financial system stakeholders based on its own strengths. At the other end of the spectrum, donors can pool resources and conduct joint programming with harmonized procedures and one voice. Many other collaborative approaches lie in between. Regardless of the model chosen, preliminary experience suggests that the key to success of true collaboration is a clearly articulated vision that is shared by all donors.

An example of good collaborative practice is the multi-donor Pro-poor Financial Sector Deepening Program (FSD Program) in Tanzania, where four donors pooled funds to support the expansion of financial services to poor people. The FSD program, led by DFID and including CIDA, Sida and the Royal Netherlands Embassy, is built on a common vision, harmonization of procedures, and a professionally-managed trust mechanism to implement capacity-building projects, mainly with financial intermediaries. The Southeastern European Funds represent another example of this kind of collaboration. In recognition of its comparative advantage in technical expertise, experience with banking instruments, and knowledge of financial intermediaries in the region, KfW manages these funds on behalf of multiple donors, including the EC, BMZ, SDC, the Austrian government, and the Netherlands Development Finance Company (FMO).

D. Develop a Joint Agenda

Donor agencies could benefit from common solutions for maximizing their effectiveness in microfinance. Three concrete examples of mutual challenges are:

Joint standards. The most recent donor guidelines for microfinance ("Guiding Principles for Selecting and Supporting Intermediaries" or the "Pink Book") were written in 1995. Donor practices have evolved since then and the time is right to update them, drawing on lessons learned from the Peer Reviews.

Rural finance. Seventy-five percent of the world's 1.2 billion extremely poor people live in rural areas. Most do not have access to formal financial services. Donor agencies struggle with the problem of adapting good practices to support rural financial services in areas that are not particularly conducive to sustainable financial service providers. Agencies could benefit from sharing resources and experiences to tackle this problem together.

Harmonization. As in other areas of development, harmonization of procedures, systems and reporting would help increase donor efficiency. Unlike other sectors, agreed standards of reporting on microfinance performance have already been established. Donors can build on existing common reporting formats, such as the multi-donor PMT in Uganda and the internet-based MIX Market, to more fully harmonize their reporting requirements.

AID EFFECTIVENESS

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